



Bombardier's bank

Ottawa must stomach a lot of risk to be in the aircraft manufacturing business

BY MATTHEW MCCLEARN

On March 17, Paul Tellier once again proved that he means business. At a press conference in Toronto's Royal York Hotel, the CEO of Bombardier Inc. (TSX: BBD.B) sternly declared that last year's performance by the ground transportation division of the Montreal-based company was a "bitter disappointment." Not one to turn a blind eye to problems, Tellier announced his painful remedy: he would shut down seven rail plants in Europe and throw 6,600 people out of work.

Tellier's axe did not fall at Bombardier's other major business, aircraft manufacturing. In fact, that division shipped 26 more aircraft in 2003 than during the previous year. The rising value of the Canadian dollar almost nullified the benefit to Bombardier's bottom line, but Tellier called the division's performance "significant progress"—particularly given the

pronounced turmoil facing the aerospace industry. He vowed to continue improving results through increased productivity, better customer service and an updated aircraft platform to suit an evolving market. One thing he didn't mention was government support. In fact, when asked by a reporter what help he wanted from Ottawa for the aerospace division, Tellier didn't mince words. "None whatsoever," he said. "There is no request and no intent to ask for any kind of support from any government."

Bombardier's message on this subject, however, seems mired in contradiction. On one hand, the company denies it is a poster child for corporate welfare. It has claimed several times to be working diligently to reduce its reliance on the public purse. It has even told international governments to "stop tampering with market forces and eliminate their support to aerospace industries."

At the same time, however, Bombardier

is aggressively lobbying for more support. The campaign is evident in Tellier's other recent speeches. In February, he called for "a Canadian aerospace policy" that would include more government funding for aircraft research and development. More importantly, it would offer more government loans to Bombardier's customers to support aircraft purchases. That's on top of billions of dollars in government loans already outstanding or available to plane buyers. "While these amounts sound quite large," Tellier said, "they appear much smaller when compared to our customers' financing needs."

This would not be the first time a government financed its aerospace industry out of a crisis. Just one example: in the early 1970s, aircraft manufacturers witnessed a plunge in market demand. The U.S. government intervened, directing the Export-Import Bank of the United States (Ex-im) to help finance the export of large made-in-U.S.A. commercial jets. Between

Bombardier CEO Paul Tellier at Toronto press conference announcing rail cuts (left); workers assemble jets at Bombardier Aerospace plant in Montreal

1967 and 1977, Ex-im lent nearly US\$5.8 billion to plane buyers. So much of it went to customers of the world's largest aircraft manufacturer that Ex-im became known as "Boeing's Bank."

But here's the thing: Whenever you lend money, you accept some degree of risk that you will not be repaid. How much risk is Bombardier's bank willing to take?

TO UNDERSTAND THE importance of government loans to aerospace, one must first contemplate the industry's unusual dynamics. Large plane manufacturers don't simply materialize by accident or from unbridled entrepreneurial spirit; wherever they exist, the hand of government has played a deliberate, nurturing role. Case in point: the remarkable ascent of Bombardier's archrival, Embraer of Brazil, owes much to that national government's largesse. Governments covet aerospace firms because of the well-paying, high-skill jobs and leading-edge technologies they create. National pride also comes into play: few countries can say they build

quality aircraft. As Tellier has noted, "Ours is a brutally competitive global environment, in which governments show no hesitation in supporting their national champion or emerging industry."

Another issue is that aircraft are big-ticket items, which can't be paid for out-of-pocket by most buyers. Bombardier told government officials last year that "regional aircraft are almost impossible to sell without financing." There are three popular sources. One, manufacturers can and do extend loans to their own customers—a practice known as vendor financing. Alternatively, buyers can approach private-sector lenders, such as HVB, Abbey National, West LB and others. Or they can obtain government loans. That's where export credit agencies come in. These agencies—such as Ex-im in the United States, Brazil's BNDES and our own Export Development Canada—help domestic companies sell abroad. One way they can do that is to extend loans to foreign customers.

In EDC's case, that means lending money to foreign airlines to buy Bombardier's aircraft. Typically, those loans are repaid over eight to 17 years, at commercial rates. EDC has extended 17 such loans since it began reporting transactions in October 2001. In the early days of Bombardier's regional jet program, such loans were instrumental in getting an untried product accepted by the market. Later, as the market matured and competition

spectre and last year's SARS outbreak conspired to reduce global air traffic. Increasing competition and the success of discount carriers depressed airfare prices. The squeeze forced some large carriers into bankruptcy protection, and tossed the entire industry into credit disarray. By Bombardier's own admission, its customers are often "highly leveraged" and have "constrained" cash flow—and their credit ratings are "rarely investment grade." Burned by the downturn, private-sector lenders lost enthusiasm for backing aircraft purchases. Bombardier, which committed US\$1 billion to finance up to 60 jet purchases in 2003, simply couldn't make up the difference. By last year, the situation was becoming acute. "Securing customer financing is Bombardier's most immediate challenge," Tellier said.

AT THE TIME of his appointment as EDC chairman, in 1998, Patrick Lavelle says he was struck by how risk management played second fiddle to the Crown corporation's efforts to increase the size of its loan portfolio. At board meetings, he recalls, EDC's management simply presented the details of large proposed loans, and the board would duly approve or reject them on their individual merits. Nobody seemed to have a clear picture of what the overall portfolio looked like. "We were basically flying blind," Lavelle says. At the first meeting he chaired, he appointed a risk management committee and hired consulting firm Oliver Wyman—the beginnings of a multi-year effort to introduce a more disciplined approach to loans.

EDC AUDIT

Total value of EDC's loan portfolio

\$21.1 bil

Total value of EDC's aerospace gross loans receivable portfolio

\$6.5 bil

Portion of aerospace loan portfolio offered to Bombardier's customers

85%

SOURCE: EDC

went to Bombardier's customers. No other Canadian company—except Nortel Networks Corp. (TSX: NT)—enjoys that level of support.

Recently, however, Bombardier has found it more difficult to scare up financing for customers. Terrorism's growing

In early 2001, Lavelle says, he learned that nearly three-quarters of EDC's \$22-billion loan portfolio was tied up in aerospace and information technology—the lion's share to customers of Bombardier and Nortel. Worse, 40% was below investment grade—meaning the portfolio was speculative. "I was appalled," Lavelle says. "I thought we were overexposed to Bombardier, that we were overexposed to these sectors of the economy, and that we had no basic strategy for bringing that under control."

Lavelle and his fellow directors soon devised one. They imposed new caps on